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The overarching message of the UK's new Labour Government's Corporate Tax Roadmap was its recognition of the need for stability and certainty. The recognition that "a stable and predictable tax environment helps to provide the confidence needed to encourage investment, innovation, and growth over the long term". The UK Government had promised to provide the certainty that businesses need and also the confidence that the UK intends to maintain its competitive position among major economies.

However, the adoption of an "America First" Trade Policy brings uncertainty for multinationals around current US policies and possible counter measures by other jurisdictions, both in terms of trade and the international taxing rules under discussion at the OECD and the UN Tax conventions. The America First policy may lead to the proliferation of tariffs or import duties and the previously agreed OECD Two Pillar solution to the operation of the international tax rules no longer has the support of the United States. With the US no longer intending to implement the Pillar One proposals, there is no longer an agreed basis for removing existing unilateral digital service taxes ("DSTs") and many other countries may look to impose their own, new DSTs. The US sees such taxes as discriminatory on the basis that they are largely aimed at the US tech giants and so may well look to impose its own retaliatory measures, again possibly in the form of more tariffs or higher taxes.

What are the likely outcomes of the current situation? There is clearly the real risk of disruption to existing supply chains and businesses must always look to de-risk their operations as far as possible. What exactly are these risks? What can and should businesses be doing in this situation? It may be that there are opportunities to simplify supply chains, for example, to mitigate, as far as possible, the cost of tariffs. Even where that is not the case, there is the question of allocating those risks within the global value chain of the business and ensuring that the contractual framework and transfer pricing policy is clear and consistent in its application in relation to such issues.

The "America First" Trade Policy

Amongst President Trump's first actions was the publication of the "America First" Trade Policy Executive Order ("EO"). Designed to prioritise US interests in international trade, this EO requires the identification of any foreign taxes which discriminate against US citizens or are extra-territorial. At the same time, President Trump aims to boost American manufacturing and jobs by lowering the corporate tax rate to 15% for corporations that make products in the US and imposing tariffs for those who choose to import goods manufactured in countries deemed to be following tax policies that the US considers to be discriminatory in nature for American interests. While details on tariffs imposed are still emerging, as the Trump Administration is analysing its trade balances and double tax treaties, it is clear that greater impact will be felt by certain sectors (e.g Steel, Health and Life Sciences) and countries (e.g Mexico, China) more than others.

While the measures announced to date have largely impacted the manufacturing and importation of goods, the provision of services is not immune to potential measures under the "America First" Trade Policy. There is a significant concern in the US that foreign countries are using tax legislation that is extraterritorial and which discriminates against US companies. There are several sources that contribute to this concern, including the application of DSTs, EU State Aid measures and the OECD Two Pillar approach to international tax rules. All are likely to be the subject of intense negotiation in the coming months.

Digital Service Taxes

On DSTs, the US has long been unhappy that foreign countries such as the UK and France have introduced taxes on digital services which primarily affect the US tech giants. In the UK, for example, the DST takes the form of a 2% tax on the revenues of search engines, social media platforms and online marketplaces which derive value from UK users. The DST yielded in excess of £600m for the 2023/24 financial year for HMRC, and it is expected that these revenues would exceed those expected to be raised by the OECD Pillar One proposals upon implementation. Over 20 countries have implemented DSTs including the UK, France, Italy, Spain, Canada, and India[1].

DSTs were generally introduced as a reaction to a perceived failure of the international tax rules to keep pace with modern business practices and the ability of many businesses, especially those operating in the digital space, to derive value from jurisdictions without having any presence there (which is required for the recognition of a permanent establishment ("PE") giving taxing rights to the host jurisdiction).

Proposals to recognise a virtual PE in some cases were eventually replaced with the current OECD Pillar One proposals. More on these below, but the important point here is that the US and various European jurisdictions (including the UK and France) signed a transitional agreement on the withdrawal of these DSTs, dependent on entry into force of the OECD Pillar One proposal. This transitional agreement was designed to forestall the threatened trade action by the US against jurisdictions imposing DSTs. With the US withdrawing from the OECD process, then there is no longer an agreed basis for the removal of these DSTs. Arguably, quite the opposite. There is therefore a real risk of a proliferation of further unilateral DSTs. From the perspective of multinationals, this is undesirable not least since DSTs often take the form of a tax on turnover (rather than profit) and may result in double taxation.

EU State Aid rules

The application of EU State Aid rules has also been seen as unfairly targeting US companies. The State Aid rules have essentially been used by the EU Commission to target arrangements or agreements which it views as amounting to the provision of a selective advantage to overseas companies. It was most recently successful in the case concerning the Irish Revenue tax rulings on Apple's tax structuring. However, other large US multinationals which have been investigated include Starbucks and Amazon. The Commission's use of State Aid in this context attracted the criticism of the US Treasury as far back as 2016 including the complaint that the "Commission's actions undermine the United States' efforts in developing transfer pricing norms and implementing the OECD/G20 BEPS project".

[1] *See "Digital Taxes Around the World"*

The OECD Two Pillar Approach

The OECD Two Pillar Approach was essentially born out of the dissatisfaction of some jurisdictions with the outcome of the 2015 BEPS process. Although, BEPS concluded that the digital economy should not be ring-fenced and treated differently to the rest of the global economy, increasing digitalisation and globalisation led many jurisdictions to consider that further action was needed to ensure fair taxation of digital business. In particular, there was broad agreement for the need for a revised approach to "nexus" for tax purposes, stemming from the perception that the current approach to the allocation of profits (based on physical presence and the "permanent establishment" definition) can no longer be the exclusive method in a digital age as it fails to recognise value created (remotely) in a market jurisdiction.

The OECD Two Pillar approach eventually sought to address these concerns through agreement of Pillar One. Pillar One allows market jurisdictions to tax a share of residual profit allocated to them (Amount A) using a formulaic approach applied at an MNE group level. This new taxing right applies irrespective of the existence of physical presence.

Pillar Two (also referred to as "GloBE") is designed to address remaining BEPS challenges by ensuring that the profits of internationally operating businesses are subject to a minimum rate of tax of 15%. A minimum tax rate on all income reduces the incentive for taxpayers to engage in profit shifting and for jurisdictions to engage in a harmful race to the bottom on corporate tax rates.

The OECD Two Pillar approach was subject to a separate EO issued by President Trump declaring that the OECD Global Tax Deal has no force or effect in the US.

It appears that there are two aspects in particular of the OECD approach that are objectionable from a US perspective. Firstly, Pillar One itself. Final agreement of the Pillar One rules has proved exceptionally difficult to reach, with continued disagreement over the precise amounts to be reallocated to market jurisdictions. The US concerns on Pillar One relate to the "potential mandatory departures from arm's length transfer pricing and taxable nexus standards – longstanding pillars of the international tax system upon which US taxpayers rely". The previous US administration suggested that these concerns could be addressed and the goals of Pillar One could be substantially achieved by making Pillar One an optional safe harbour regime. In essence, in exchange for paying more foreign tax under a Pillar One election, the MNE would obtain the benefits of enhanced tax dispute resolution and administration It now appears that the US will not sign up to Pillar One.

Secondly, there are aspects of the GloBE rules that the US do not appreciate. In particular, the extension of the Pillar Two approach to include the undertaxed profits rule ("UTPR"). Whilst the basic GloBE rules largely work in a way similar to CFC rules to top up taxes of subsidiaries to 15%, the UTPR will go much further. This will allow jurisdictions to impose additional taxes on members of an MNE group that pay less that the global minimum of 15% in another jurisdiction, including where the ultimate parent company fails to pay 15%. As such, assuming that the US does not apply the GloBE rules domestically, then other jurisdictions will potentially be in a position to charge domestic group companies additional taxes on the basis that their US parent is subject to tax at a rate less than 15%. This would appear to fall squarely within the scope of the discriminatory tax measures President Trump aims to discourage. Thirty countries are planning to adopt the UTPR by the end of 2025, including the UK, Australia, Canada and certain EU member states[2].

[2] *See "Corporate Tax Rates Around the World, 2024"*

What next?

Most obviously, the future of the universal application and administration of the OECD Two Pillar approach has been thrown into doubt. While, many jurisdictions have already implemented the 15% GloBE rules, the UTPR aspects of the rules have not yet been fully implemented and there is now the threat of US retaliatory action should they be applied in relation to US headquartered groups. Both the UK and EU are currently committed to bringing in the UTPR with effect for financial periods beginning on or after 31 December 2024. It is not currently clear if or how the threat of US retaliatory measures will impact this extension of the GloBE rules.

However, there seems little prospect of the Pillar One rules now making further progress (or at least the Amount A aspect). With the target of Pillar One being in large part US tech giants and the US now refusing to implement Pillar One, any chance of agreement in the short term over the recalibration of taxing rights in relation to digital businesses seems remote to say the least. Of course, with the failure of the US to implement Pillar One, any prospect of renewing the earlier agreements over the removal of DSTs also appears to fall away. These agreements had technically expired in 2024 and the big question for countries such as the UK and France is now whether they will continue to impose DSTs in the face of potential US action. From an Exchequer perspective, DSTs present a significant revenue source (and there was no guarantee that the OECD Pillar One proposals provided a fairer and more agreeable approach for attribution of tax revenues to jurisdictions on the basis of the location of the consumption of goods and services). The EU has previously considered the introduction of an EU wide DST and there are suggestions that, with the failure of Pillar One, this might return to the agenda.

President Trump's EOs require the production of various reports into discriminatory or extra-territorial taxes, America's trade policy and the establishment of an External Revenue Service ("ERS") to collect tariffs, duties, and other foreign trade-related revenues, which are due by the end of March or early April. These may throw additional light on the scope of the challenge ahead. The US is also known to be concerned over other perceived extra-territorial tax measures such as the UK's diverted profits tax rules. However, it is at this stage unknown how such tax measures might influence the US trade policy with the UK.

We have already seen with the threatened imposition of tariffs on Mexico and Canada, that the new US administration is willing to use tariffs in part as a bargaining chip to achieve its aims. It seems likely that its approach to DSTs (and the UTPR) will likely also include the threat of targeted tariffs. Though wider action is possible as President Trump also looks at using section 891 of the US Internal Revenue Code and a further section to be introduced by the Defending American Jobs and Investments Act to increase (potentially double) US taxes on individuals and corporations in countries which are considered to have discriminatory or extra-territorial taxes. It is possible that we will see in response a round of bilateral negotiations between affected jurisdictions and the US. As a result, it is perhaps too early to say whether the failure of the OECD Pillar One approach will lead to a further proliferation of DSTs or a roll-back of DSTs on the basis of bilateral agreements.

Of particular concern are recent suggestions that even VAT may be seen as a discriminatory tax on US exports. Quite apart from fundamentally misunderstanding the nature of import VAT (which levels the playing field between domestic and imported goods), this puts the whole of the EU and the UK in the firing line for retaliatory measures.

On the one hand, it seems clear that the imposition of tariffs and other measures is intended in part to fund the US government and its intended tax cut for US manufacturing. On the other hand, there is some evidence that President Trump may be seeking to use the threat of tariffs to bargain with international partners, as with the temporary delay in the application of announced tariffs on Mexico and Canada. As a result, we may see much bilateral negotiation in the months and years ahead.

What can businesses do?

Is there anything that businesses operating internationally can do in the face of increased uncertainty and costs?

The imposition of tariffs will inevitably result in significant increases of costs across multiple points in companies' supply chains. At the very least, businesses should be considering where in their current supply chains these risks may arise and, to the extent possible, what the associated costs may be. Consideration should be given to whether any pre-emptive actions might be taken to mitigate the risks and thereby reduce the costs. These might involve optimising or simplifying supply chains to minimise inefficient intercompany transactions that result in leakage from a customs duty perspective or even relocating activities either to or from the US or from other jurisdictions likely to be impacted by US tariffs. Clearly, it may be too early to undertake costly restructurings at this early stage of developments, but it is never too early to identify risks and opportunities.

At a minimum, multinationals should review what is included in the underlying transaction value of the imported goods. Have the costs of other services or the value of intangible assets been bundled into the value of the imported goods? If so, it could be possible to exclude these amounts to minimise the amounts subject to customs duties. It may be the case that these levels of disaggregation have proven too challenging for many multinationals to warrant the savings in duties to date. Given the proposed levels of tariffs to be imposed, disaggregation of intercompany values to derive the basic transaction value may now be a viable cost saving to pursue.

Businesses should also be reviewing their transfer pricing policies and intercompany agreements. What do these contractual arrangements stipulate with respect to the conduct of the parties, and the financial capacity and control of risk? Is the right related party bearing the risks and the associated additional costs associated with the importation of the goods? A particular concern may involve the financing of any additional costs involved in the supply chain, including tariffs. What transfer pricing arrangements will need to be put in place to support this funding or any restructuring?

MAP and APAs

There is also the risk that companies operating internationally will get caught up in disputes with tax jurisdictions over their operations. This is particularly the case in relation to new or restructured supply chains. Consideration should be given to the use of Advance Pricing Agreements ("APAs"). In the ordinary course, these can provide tax certainty for businesses. In the UK, HMRC's approach is to work primarily with the tax administrations of other jurisdictions to make bilateral or multilateral agreements, rather than unilateral agreements. This requires discussion and negotiation with treaty partners. As a result, the time taken to conclude an APA is usually measured in years rather than months.

HMRC's recently published "Transfer Pricing And Diverted Profits Tax statistics: 2023 to 2024" indicates that the average time to reach agreement for the 27 APAs reached in 2023/24 was 4 years and 5 months! The more positive aspect is that the 27 APAs concluded during this period was the highest since 2018/19. The length of time taken to reach agreement (which has increased from 33 months over the same period) has not however reduced the appetite for APAs, with 2023/24 seeing the joint highest number of applications during the year (45).

Most double tax agreements include a Mutual Agreement Procedure ("MAP") article allowing tax administrations to resolve cases of double taxation by consultation and mutual agreement. HMRC has a good record using MAP to resolve transfer pricing cases. On average, cases are resolved within 25 months, which is better than the international average of 32 months.

However, as the United States has pulled out of the process to agree the OECD Two Pillar solution and the UN Framework Convention on International Tax Cooperation, the regular process for reaching dispute resolution may be curtailed. A further complication in this context is that developing countries are pushing to continue negotiating a global tax treaty under the UN banner, because they perceive that the OECD initiatives ignore their unique circumstances. This could create a myriad of additional complexity and uncertainty for businesses to navigate with respect to the application of double tax treaties. While dispute resolution through MAP and/or Multilateral Instruments may take on even greater significance in this environment, governments may seek to become more protective of their tax base on a unilateral basis and reaching agreement with one tax authority may help multinationals in any future tax disputes that may arise.

Comment

There are many uncertainties that have been created by the change in US policy regarding free trade and the OECD Two Pillar model. Added to this is the developing countries desire to take forward an alternative approach to the OECD model tax treaty through the United Nations. Digital service taxes and other extraterritorial measures designed to protect domestic tax bases are likely to incur the displeasure of the US with the threat of tariffs and/or a potential doubling of tax on companies or individuals coming from offending jurisdictions.

Businesses operate best in a stable, consistent tax environment offering tax certainty. Such certainty may be too much to hope for in the near future, but businesses should be taking the opportunity to review their existing supply chain arrangements with a view to considering opportunities to reduce the impact of the risk of tariffs or higher taxes or, where that is not possible, allocate these risks on a consistent basis.

What can Simmons & Simmons do to help?

Simmons & Simmons can help companies review their supply chains and discuss any risks and opportunities that might exist, with a focus on reviewing:

- Transaction values of imported goods to determine whether disaggregation of intercompany services or intangibles is possible.
- Intercompany contractual relationships to ensure that the conduct is in line with the terms set out in the agreements.
- Uncertain tax positions and outstanding tax audits or disputes.

S&S can support multinationals with any discussions or submissions with tax authorities to achieve certainty on a proactive basis.

Contact

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